McKinsey & Company

Insurance and Private Equity & Principal Investors Practices

Creating value in US insurance investing

Despite market complexity, many opportunities exist for private equity players to create value in insurance. We studied the US industry and offer a set of investment recommendations to guide PE firms' decisions.

by Ramnath Balasubramanian, Matthew Scally, Ruxandra Tentis, and Grier Tumas Dienstag

© EduLeite/Getty Images

November 2020

In recent years, private equity (PE) firms in the insurance industry have realized impressive returns. They have profited from multiple arbitrage, particularly in the heavily fragmented insurance brokerage space. PE-backed providers of distribution technology—such as performance-marketing and agency-management players—have recorded fast growth while maintaining strong cash flows. Investors have also created value in insurance services by building dominant positions in the relatively mature claims-management space and by consolidating human resource information systems (HRIS) and benefits-administration services on the same platform.

PE firms are also completing many more insurance deals, which now account for almost half of total financial services' PE deal volume (by number of transactions), up from one-third in 2013.[1] From 2016 to 2019, the PE-backed brokerage deals completed in the United States accounted for roughly three-quarters of the total insurance deal volume (in terms of the number of transactions). Given record levels of available capital and successful exits, PE activity and competition for insurance assets has intensified. PE investors also must compete with conglomerates and insurers themselves that are investing more money, more often. As a result, multiples are high and holding.

Further complicating matters, trends and macroeconomic forces, most notably the COVID-19 pandemic, are reshaping the value-creation levers of the past. To varying degrees, the pandemic is causing ongoing disruption. It has adversely influenced the top line for many product segments and will prolong the persistent low-interest-rate environment, which continues to squeeze insurers' profitability. Drastic improvements in productivity are likely necessary to maintain profitability in this low-interest-rate (and often lower-premium) environment.[2] And amid an economic downturn in which pure multiple arbitrage may not be possible, operational value creation becomes even more important. Moreover, there is added opportunity for private capital to take undervalued public companies private.

To shed light on potential investment opportunities in insurance, we took a comprehensive look at the value-creation levers in the industry. To facilitate our analysis, we classified insurance-related companies as distribution players, service players, or technology providers. In addition to investing in these insurance ecosystem providers, many leading PE firms have shifted to employing permanent capital from insurance balance sheets to drive growth. Here, we articulate potential investment recommendations for the three ecosystem segments to guide PE investors as they navigate this complex and dynamic industry in the years to come. In addition, we articulate the rationale for investing in insurance balance sheets as permanent sources of capital.

Distribution

Services providers and distribution companies outside of personal auto and homeowners are historically the most popular and profitable for PE deals in insurance, achieving more than 15 percent EBITDA[3] margins (exhibit).

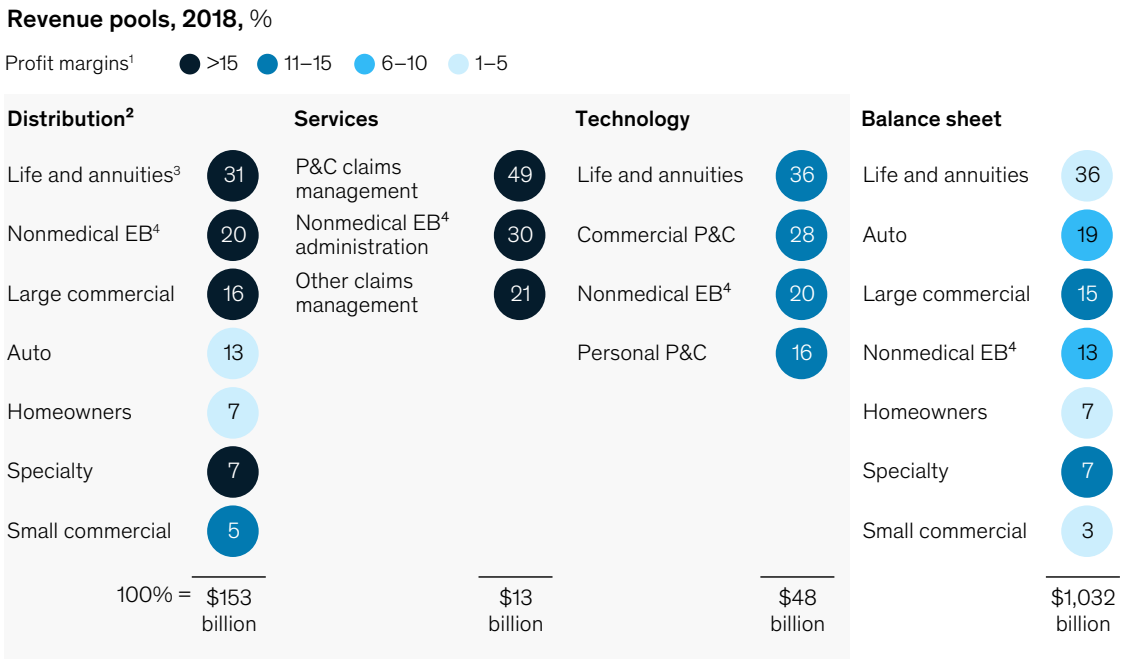
The COVID-19 pandemic has changed the distribution landscape, though long-term effects remain uncertain. New-business premiums for North American life and annuities dropped by about 10 percent in May 2020 but had more than recovered by July. While new business in most commercial property and casualty (P&C) segments has declined, the market continues to harden, or increasing rates will have positive effects on revenue.

Personal lines are expected to be less affected by the economic fallout of the pandemic, but new auto policies will likely decline as GDP declines.[4]

[1] McKinsey analysis of PitchBook and Capital IQ data, accessed January 17, 2020.
[2] Alexander Erk, Pradip Patiath, Jonathan Pedde, and Jasper van Ouwerkerk, "Insurance productivity 2030: Reimagining the insurer for the future," October 8, 2020, McKinsey.com.
[3] Earnings before interest, taxes, depreciation, and amortization.
[4] For more on the effects of COVID-19 on life and annuities and P&C, see Ramnath Balasubramanian, Alexander D'Amico, and Jonathan Godsall, "Implications of coronavirus for North American life and annuities writers," April 21, 2020, McKinsey.com; and Ari Chester, Sylvain Johansson, Steven Kauderer, Erwann Michel-Kerjan, and Andy Pinkes, "Coronavirus response: Short- and long-term actions for P&C insurers," April 14, 2020, McKinsey.com.

Exhibit

For insurance investments, opportunities in distribution, services, and technology are more profitable than balance-sheet opportunities.



[1]EBITDA margins for distribution, services, and technology.
[2]Figures may not sum to 100%, because of rounding.
[3]Based on external expert interviews.
[4]Employee benefits: sum of group accident and health from P&C, life, and health books; excludes major medical; direct premiums earned.
Source: S&P Global Market Intelligence

Previous recessions have shown that insurance brokerage industry is not immune to declining economic activity. Historically, however, the industry has proven resilient, and institutions more adaptable to the new realities of working—such as businesses with digitally focused and enabled sales forces and infrastructure to withstand exacerbated cyber exposures—will outperform others. These institutions may also have the opportunity to acquire distressed sellers and hire strong producers.

Pursue organic growth and productivity in middle-market and employee-benefits brokerage

Investors will continue to find opportunities to profit from M&A roll-ups and multiple arbitrage in the highly fragmented middle-market and employee-benefits (EB) brokerage space. A long tail of targets is available, including more than 30,000 middle-market and 8,000 EB brokerages. However, some of these brokerages that are small businesses themselves rely heavily on paper or face-to-face interactions. Also, brokerages that primarily serve small enterprises may struggle to survive in the current environment, and valuations are likely to come down as a result. Additionally, small enterprises (the most common customers for middle-market brokerages) are most susceptible to prolonged economic challenges. Therefore, PE firms will need to look for new sources of value, such as organic growth and productivity—for example, optimizing insurer and wholesale pricing strategies, digitizing, and using analytics at scale—to drive growth in the future.

Invest in the alternative distribution channels of life-and-annuities managing general agents and insurance marketing organizations

PE investors are increasingly looking outside of P&C and EB retail brokerage for opportunities. The still-fragmented space of life and annuities

managing general agents (MGAs) and insurance marketing organizations (IMOs) has recently attracted investor attention. A handful of PE firms have acquired IMOs, furthering consolidation in the space. One leading IMO has acquired more than 20 companies since 2018. This consolidation occurred despite the expected decrease in overall life and annuities sales, as lower face-amount policies that do not require a medical underwriting exam are more easily sold via phone or digital platforms and may prove resilient. In fact, amid the COVID-19 pandemic, traffic to online life insurance sites has increased, suggesting a near-term, growing interest in life insurance products.

Deepen penetration with marketing players, digital brokers, and aggregators

In personal P&C and small commercial lines, many technology companies are vying for a share of insurers' digital marketing spending and commissions. Prior to the COVID-19 pandemic, this spending was growing, and that growth continues as face-to-face sales become nearly impossible. Because analytics now make it easier for insurers to assess ROI, they are increasingly comfortable outsourcing to digital intermediaries the work of generating leads, recommending products to clients, and offering them advice. PE firms have historically invested in performance-marketing players to expand their digital marketing capabilities, while other intermediaries have attracted investments from incumbents.

Services

Many insurers have seen their valuations reduced in recent months, and there is ongoing uncertainty about the environment. High expense ratios are likely to become more prevalent, and many insurers are looking to reduce overall spending, potentially by outsourcing some activities to third-party service providers.

Yet service providers also face a potential challenge: the COVID-19 pandemic has lengthened the time it takes for policy administration and claims processing. Offshored services, in particular, initially faced significant disruptions. For example, prior to the start of the pandemic, workers were required to check cell phones at the office door to protect information, a policy that needed to be completely rethought in new work-from-home arrangements. While the short-term disruptions have been resolved, they have prompted insurers to reconsider business resilience plans and increase efforts to automate. This shift will likely affect demand for claims services, as frequency of claims initially decreased in some lines such as auto (as fewer individuals drive) and workers' comp (as fewer employees are on the payroll). The number of claims has started to increase, however, as many places reopen. In addition, demand for claims services in disability and the need for fraud mitigation across lines have increased.

As small enterprises falter and employers of all sizes lay off employees, benefits administration and HRIS players will also face significant pressure on profits. Given that the majority of revenue for benefits administration and HRIS players comes from a base fee plus "per employee per month" (PEPM) pricing, any players overindexed on particularly hard-hit industries (such as travel and leisure) will face revenue compression, and players focused on small and medium-size enterprises will be further affected by business closures that lead to lost base fees. Furthermore, revenue sharing, another source of income for benefits administration and HRIS players, will also likely decline as employers and employees drop insurance policies.

Strengthen claims-management-dominant positions through automation and analytics

In the past, PE firms have generated value in claims through acquisition—they realized scale efficiencies and expanded to additional products and parts of the value chain. This activity, however, has created dominant players that have left very few attractive acquisition targets in the market. Going forward, PE-backed players can combine continued

acquisition with efficiency-focused and value-added services to insurers in the downturn.

Prioritize end-to-end employee engagement platforms in benefits administration and HRIS
PE firms have consistently invested in the benefits administration and HRIS space, as well as in professional employer organizations (PEOs). Firms have prioritized investments with "sticky" revenue, direct employee connectivity, payroll outsourcing services, opportunities for M&A roll-up, and scale benefits. We expect an overall trend toward consolidation to continue with more providers offering both HRIS and benefits-administration services on the same platform. Such players use work-site selling and decision-support tools to drive benefits adoption and become more active partners for brokers and employers.

Technology

Technology providers are benefiting from a booming ecosystem of start-ups that help insurers automate their businesses. Influenced by the current environment, insurers are using analytics to increase process efficiencies that reduce costs and to evaluate large sets of data to generate other insights. Robotic process automation and intelligent process automation, combined with cognitive automation and analytics across business lines, drive productivity and accuracy in business processes with near-zero error rates.

Expand distribution technology into integrated solutions and ancillary offerings
PE firms have backed distribution technology players, including agency management systems (AMS) that have recorded consistent growth and maintained strong cash flows. AMS and other distribution technologies have created value through increases in pricing, penetration, and cross-selling ancillary solutions.

Pursue end-to-end solutions and optimize existing core-process technology
Demand for core-process technology, including policy administration, has grown and become especially prominent in personal and commercial lines P&C and group benefits. Today, to keep pace with product innovation and online and direct capabilities, more insurers are turning to third-party solutions, which allow insurers to modernize their tech stacks and every step of their processes. Such solutions are sticky, on account of ten-year or longer replacement cycles and stable cash flows.

Invest in automation, analytics, and data in claims technology
The claims services and technology market is highly concentrated. PE firms have owned a few large

Influenced by the current environment, insurers are using analytics to increase process efficiencies that reduce costs and to evaluate large sets of data to generate other insights.

players for more than a decade and may be looking to exit when there is less volatility. Current PE owners have invested in operational efficiencies and pricing optimization. More recently, these providers are looking to evolve into end-to-end claims decision players through automation and analytics.

Insurance balance sheets as a source of permanent capital

The permanent capital residing on insurance companies' balance sheets has become a key growth driver for many PE firms. Our analysis shows that in 2020, insurance-related capital accounted for 15 to 40 percent of total assets under management of many of the world's leading PE firms. Insurance capital delivers on several investment objectives. It is long-term capital with a life cycle beyond that of a typical fund, particularly for alternative asset classes such as credit and real estate. It provides a stream of fee-related income, which in turn provides a diversified source of earnings and is seen as a major valuation driver, particularly for publicly listed firms. And it is an attractive investment opportunity on a stand-alone basis, as its comprehensive value-creation approach delivers 10 to 14 percent internal rates of return. As the persistent "lower for longer" rate environment puts even more pressure on insurance balance sheets, and as insurers seek higher returns to meet their commitments and obligations to policyholders and regulators, we are likely to see a further acceleration of growth in permanent capital over the next few years.

Much remains to be done globally to respond to and recover from the COVID-19 pandemic, from supporting victims and families to fully understanding the pandemic's implications for business and employment. Investors will need to evaluate their portfolios and assess where the greatest risks lie and where they can deploy capital that will help the insurance ecosystem evolve and better serve all of its participants.

As we consider the evolving insurance ecosystem and private investors' role in it, there are bright spots in PE insurance investing, despite the uncertainty. Opportunities exist with distribution players and service and technology providers. By acting quickly and making bold moves using our eight investment recommendations as a guide, private equity investors can create value in this complex and dynamic industry.

Ramnath Balasubramanian is a senior partner in McKinsey's New York office, where **Matthew Scally** is a partner; **Ruxandra Tentis** is a partner in the Boston office, where **Grier Tumas Dienstag** is an associate partner.

The authors wish to thank Emma He, Siddharth Sharma, and Katka Smolarova for their contributions to this article.

Copyright © 2020 McKinsey & Company. All rights reserved.

Contact

To connect with someone on this topic, please contact:

Ramnath Balasubramanian
Senior partner, New York
Ramnath_Balasubramanian@McKinsey.com

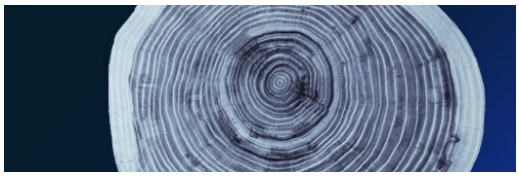
Ruxandra Tentis
Partner, Boston
Ruxandra_Tentis@McKinsey.com

Matthew Scally
Partner, New York
Matthew_Scally@McKinsey.com

Grier Tumas Dienstag
Associate partner, Boston
Grier_Tumas_Dienstag@McKinsey.com

Further insights

McKinsey's Insurance Practice publishes on issues of interest to industry executives. Our recent articles include:



The future of life insurance: Reimagining the industry for the decade ahead

State of property and casualty insurance 2020

How to win in insurance: Climbing the power curve

Reimagine insurance: Five keys to innovation